

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Chesbro Analyst: Marion Mann DeJong Bill Number: SB 2176
Related Bills: See Legislative History Telephone: 845-6979 Amended Date: 08/07/2000
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Insurance Interest Expense/Dividend Deduction/Remove Commercial Domicile Limitation on Dividend Receipts

SUMMARY OF BILL

This bill would do the following:

- ?? Allow corporations to deduct interest expense attributable to dividends received from an insurance company subsidiary that are deductible from income.
- ?? Specify that Revenue and Taxation Code (R&TC) Section 24425, which denies a deduction for expenses relating to the production of income that is not included in the measure of California tax, would not apply to expenses related to deductible dividends received from insurance companies.
- ?? Remove the commercial domicile restriction from R&TC Section 24410, thereby permitting all corporations, regardless of commercial domicile, to deduct dividends received from an insurance company subsidiary.
- ?? Declare legislative intent that the changes made by the bill should not be construed to have any effect on the interpretation or application of R&TC Sections 24344, 24410 and 24425 prior to the effective date of the bill.

SUMMARY OF AMENDMENTS

The August 7, 2000, amendments deleted the prior version of the bill in its entirety and replaced it with the provisions discussed in this analysis. As a result, the department's prior analyses of this bill no longer apply.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 1125 (1999) was identical to this bill. The Governor vetoed SB 1125 on October 10, 1999, with the following message: "Allowing corporations to deduct an expense related to income that is excluded from taxation would be neither fair nor in keeping with sound taxation principles. By allowing a double benefit for corporations with respect to dividends received from insurance subsidiaries, this bill would set a precedent for other taxpayers to seek similar treatment."

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Gerald H. Goldberg

8/29/00

SB 1229 (Stats. 1999, Ch. 987) would have removed the commercial domicile restriction from R&TC Section 24410. However, SB 1229 was tied to SB 1125 so that if only SB 1229 were enacted, only technical changes would be made, not the commercial domicile change. SB 1125 was vetoed; thus, SB 1129 made only technical changes to R&TC Section 24410.

SB 2171 (2000) would resolve a constitutional issue by removing from R&TC Section 24410 the prohibition on corporations that are commercially domiciled outside of California from deducting dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax. All corporations would be permitted to deduct dividends, regardless of where commercially domiciled. SB 2171 would apply to all open years. SB 2171 is being held in the Senate Appropriations Committee.

PROGRAM HISTORY/BACKGROUND

Insurance companies in California are taxed by levying a flat percentage tax (2.35%) on their gross written premiums, with certain deductions. This tax is imposed under Article XIII, Section 28 of the California Constitution and is intended generally to be "in lieu of" all other taxes or methods of taxation. Thus, a corporation engaged in the insurance business is not subject to the Bank and Corporation Tax Law and is not included in a unitary group's combined report.

Many insurance companies have adopted a structure in which the parent corporation (which is subject to the Bank and Corporation Tax Law) is a holding company with an insurance company subsidiary. One advantage of this structure is that the parent holding company can borrow and invest where the insurance company subsidiary is prohibited from doing so for regulatory reasons.

To prevent double taxation (gross premiums tax on the insurance company subsidiary and taxable dividends to the corporate parent), a dividend deduction was enacted in the Bank and Corporation Tax Law to the extent the dividends arose from activities in California (since the payor's income from which the dividend was paid was subject to California gross premiums tax).

SPECIFIC FINDINGS

Federal law allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership); 80% of the deduction is allowed when received from a corporation which is at least 20% but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of the recipient corporation's recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividend received deduction, capital loss carryback and certain special deductions are not allowed.

Federal law generally allows a deduction for interest paid or accrued during the income year on a corporation's indebtedness. However, that deduction is disallowed to the extent attributable to the production of exempt income.

Current state law provides for the use of an apportionment formula when assigning *business* income of multistate and multinational corporations to California for franchise tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income.

Each factor is the ratio of in-state activity to worldwide activity. *Nonbusiness* income from intangible property is generally allocated to the taxpayer's commercial domicile. *Nonbusiness* income from tangible property is generally allocated to the physical location of the property.

California Regulation Section 25120(c)(4) applies transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends will also be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose which furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials (Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., March 2, 1983).

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities. **Current state law** (R&TC Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

Current state law (R&TC Section 24402) excludes from taxable income a portion of any dividends received in taxable years beginning after 1989 that are paid out of income that was subject to either the franchise tax, the alternative minimum tax or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level. The exclusion is in the form of a deduction from gross income. For the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. In making this computation, a formula is used, allocating within and without the state certain items, such as federal income tax, which affect earnings and profits but which do not affect the income taxable for California tax purposes.

Once California deductible dividends have been computed, the deduction is further limited in a manner similar to the federal stock ownership rules. One hundred percent of the computed deduction is allowed when received from a corporation more than 50% owned by the recipient; 80% of the computed deduction is allowed when received from a corporation which is at least 20% but less than 50% owned; and 70% of the computed deduction is allowed when received from a corporation less than 20% owned.

Under current state law (R&TC Section 24410), corporations *commercially domiciled in California* are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources and determined by applying a special three-factor formula.

The rationale for R&TC Section 24410 is to provide similar relief from double taxation as is provided to general corporations under the dividends received deduction of R&TC Section 24402. R&TC Section 24410 essentially determines the hypothetical income that would have been properly imposed on an insurance company if it were subject to the franchise tax and treats the gross premiums tax as having been imposed on that income.

When R&TC Section 24410 was enacted (Stats. 1968, Ch. 1379), essentially all dividends were thought to be nonbusiness income unless receipt of dividends was the taxpayer's principal trade or business (e.g., dealers in stocks and securities). This theory was based on pre-Uniform Division of Income for Tax Purposes Act (UDITPA) case law that held the source of the dividend income was the shares of stock and the situs of such stock was traditionally the commercial domicile of the investing corporation (Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48 (1945)). Earlier versions of California Regulation Section 25120(c)(4) reflected this theory.

Subsequently, California case law held that dividends could be business income if the dividends met the transactional/functional tests implicit in R&TC Section 25120, and that the (former) FTB regulations were invalid because they were contrary to those statutory tests (Appeal of Standard Oil Company of California, supra.). The Franchise Tax Board amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as business or nonbusiness income.

Because dividends can be treated as business income, the commercial domicile restriction in R&TC Section 24410 operates as a preferential treatment only for California commercially domiciled corporations. Recent court decisions have found similar laws to be facially discriminatory against interstate commerce, without legitimate local purpose, and thus unconstitutional (e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine (1997) 520 U.S. 564, 137 L. Ed. 2d 852). Thus, it is likely that R&TC Section 24410 would be found unconstitutional to the extent the deduction is allowed only to a California domiciled corporation as discriminatory against interstate commerce.

Current state law generally provides a deduction for all interest paid or accrued on business debts. However, California restricts interest expense deductions of corporations subject to allocation and apportionment when their total interest expenses, less expenses deducted in arriving at net nonbusiness income, exceed business (apportionable) interest income. Deductible interest attributable to nonbusiness income includes interest that is deductible for federal purposes and incurred for foreign investment, which may be offset against deductible dividends (under R&TC Section 24111). The purpose of the "interest offset" is to limit interest expense deductions attributable to the production of nonbusiness income not included in the measure of the California tax¹.

Current state law (R&TC Section 24425) denies a deduction for all expenses, including interest expense, relating to the production of income that are not included in the measure of California tax.

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power to declare a statute unenforceable or refuse to enforce a statute on the basis that it is unconstitutional or that federal law or federal regulations prohibit the enforcement of such statute. The agency must continue enforcement until an appellate court has made a determination that the law is unconstitutional or that federal law or federal regulations prohibit the enforcement of such statute.

This bill would allow corporations to deduct interest expense attributable to dividends received from an insurance company subsidiary that are excluded from income (pursuant to the dividends received deduction of R&TC Section 24410).

This bill would specify that R&TC Section 24425 would not apply to any expenses, not just interest expenses, related to deductible dividends that a corporation received from an insurance company subsidiary operating in California and subject to the gross premiums tax.

This bill also would remove the commercial domicile restriction from R&TC Section 24410. Thus, all corporations, regardless of where commercially domiciled, would be permitted to deduct dividends received from an insurance company subsidiary.

Finally, **this bill** would make minor technical changes to R&TC Section 24410 and declare legislative intent that the changes made by the bill should not be construed to have any effect on the interpretation or application of Sections 24344, 24410 and 24425 prior to the effective date of the bill.

¹ In *Hunt-Wesson, Inc. v. Franchise Tax Board*, 145 L.Ed. 2d 974: (2000) __U.S. __, the U.S. Supreme Court ruled that California's interest offset provision is unconstitutional. The Court ruled that the interest offset provision is not a reasonable allocation of expense deductions to the income that the expense generates, and therefore constitutes impermissible taxation of income outside California's jurisdictional reach in violation of the Due Process and Commerce Clauses. In response to the *Hunt-Wesson* decision, department staff has instructed taxpayers to use direct tracing for assigning interest expense between business and nonbusiness income. If interest expense cannot be directly traced, then a proportional method, such as a ratio of gross income or a ratio of assets, is acceptable.

Policy Considerations

This bill would raise the following policy considerations:

- ?? Proponents argue that holding companies should be allowed to invest in their subsidiary insurance companies and receive tax deductible dividends from the subsidiaries without having to reduce the deduction for interest incurred in borrowing the invested funds. Proponents' rationale is that the dividends paid by the subsidiaries have already been "taxed" under the insurance gross premiums tax.
- ?? Currently, with respect to any corporation (including a holding company) receiving deductible dividends from a non-unitary subsidiary in any line of business, the interest deduction of the corporation is subject to the R&TC Section 24425 deduction limitation rules. Thus, this bill would place corporations (including holding companies) with insurance subsidiaries in a more favorable tax position than corporations (including holding companies) with general corporation subsidiaries.
- ?? There does not appear to be any specific tax policy to support relief from double corporate taxation only for California domiciled holders of insurance company stock. Further, the objective of R&TC Section 24410 appears to be the same as the objective of R&TC Section 24402 -- to provide relief from double taxation. The commercial domicile restriction of R&TC Section 24410 was probably included because, at the time of original enactment, such dividends generally were thought to be nonbusiness income and thus were allocated to commercial domicile. By removing the commercial domicile restriction from R&TC Section 24410, this bill would make the tax policy of R&TC Section 24410 consistent with R&TC Section 24402.
- ?? Since the commercial domicile restriction is likely unconstitutional, its removal should apply to all open years rather than prospectively to provide relief for all taxpayers.

Implementation Considerations

Since the removal of the commercial domicile restriction from R&TC Section 24410 would apply only prospectively, the department would be required by the California Constitution to enforce the restriction for prior years, unless and until an appellate court declares California law to be unconstitutional or in violation of federal law.

Implementation of this bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The dividend deduction issue would result in unknown revenue losses annually (beginning January 1, 2000) that cannot be quantified due to data limitations. Removing the expense deduction limitation, however, is expected to reduce revenues as follows:

Estimated Revenue Impact for Removing the Expense Deduction Limitation [\$ In Millions]				
2000-01	2001-02	2002-03	2003-04	2004-05
(\$2)	(\$3)	(\$3)	(\$5)	(\$5)

In the department's analysis of SB 1125 (1999) the estimated revenue loss of the expense deduction limitation was \$1 million annually. The estimate of revenue losses was increased, as reflected in the above table, based on additional information provided by audits.

Tax Revenue Discussion

Sufficient data do not exist to estimate the magnitude of losses resulting from removing the commercial domicile restriction from Section 24410 dividends. Even without this bill, revenue losses are likely as the result of cases testing the constitutionality of the current statute under which only commercially domiciled corporations are allowed the partial dividend deduction.

Removing the expense deduction limitation for insurance company dividends would result in revenue losses annually. Expenses directly traceable or allocated to income not included in the measure of tax (dividends deducted under Section 24410) would determine the revenue impact of removing the expense deduction limitation.

The estimate for removing the expense deduction limitation consists of two groups: (1) parent corporations domiciled in California and (2) parent corporations domiciled outside of California. For parent corporations domiciled in California, audit data were collected for recent audit cycles. Audit assessments have been issued because taxpayers either did not allocate expenses or used a method the department believes is inappropriate for allocating expenses to dividends deducted under Section 24410. It is assumed a majority of these assessments are sustainable. Projected sustainable assessments were grossed up to account for corporations currently complying on a self-assessed basis. The net estimate for the California-based corporations was further grossed up to allow for non-California based corporations. Cash flow estimates above reflect timing of foregone audits of taxpayers not complying under current law.

BOARD POSITION

Pending.

At its July 6, 1999, meeting, the Franchise Tax Board voted 2-0 to support SB 1125 (a bill identical to this bill).